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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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EMOTIONS. Arguing with the averages can be an expensive pastime; those who insist on doing so usually end up poorer but (unfortunately) seldom wiser. Regardless of my bullish or bearish personal inclinations, my job is to interpret the price movements to the best of my ability. It is, of course, beyond the scope of any man to think or write with complete impartiality, and this is particularly true in the present world of news flashes, television, newspaper headlines and frenetic market services. Yet the practice of Dow Theory requires that one draw unemotional inferences from the pattern of the averages, and I, for one, have never made a plug nickel when I did otherwise. I do not know exactly how many people read these Letters, perhaps four or five thousand, but I am willing to bet that not three hundred believe in the Theory the way I do. Rhea once said that it takes a full bull and bear cycle and perhaps two to five years of actual experience before a man is ready to put his money on the averages.

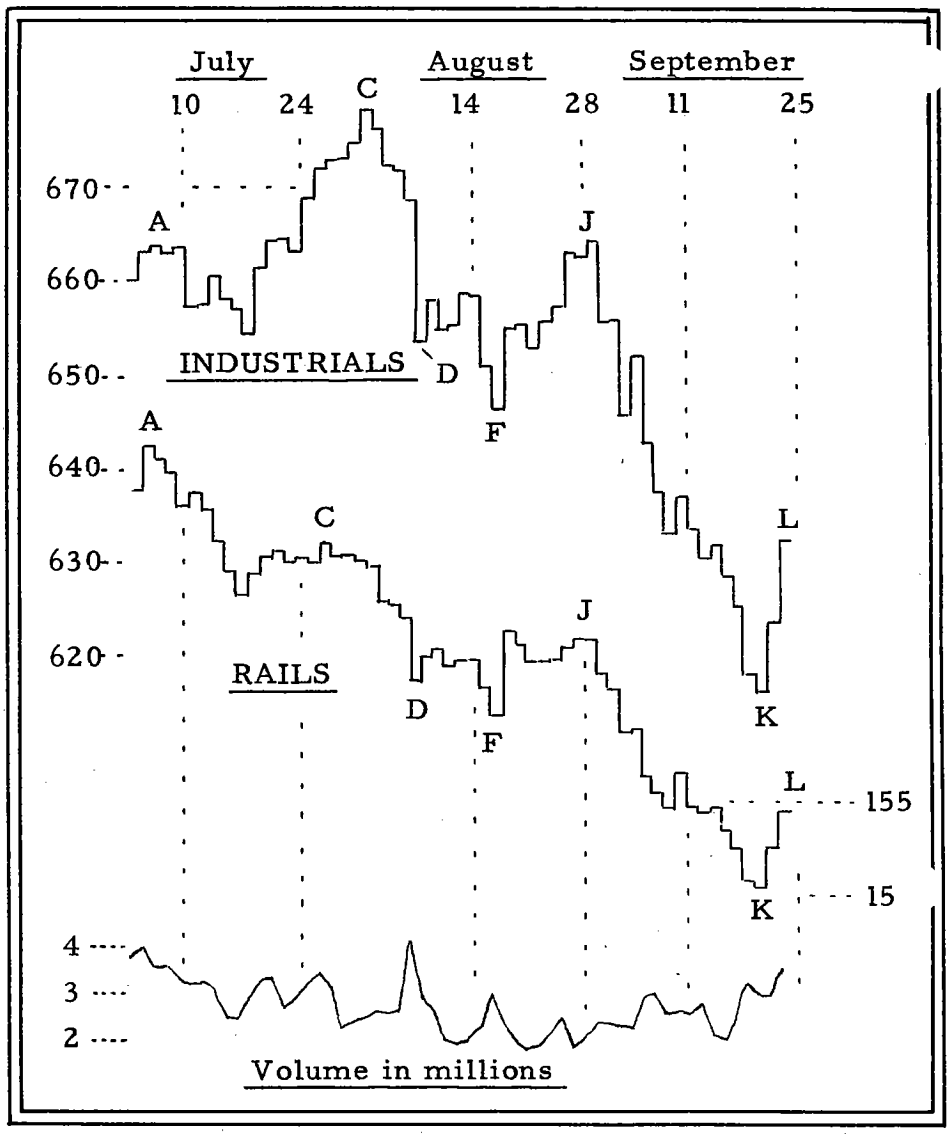
In the Letter of August 14 (Number 75) I drew attention to the first high volume penetration (D on chart), and I noted that "the danger signals are flying". Letter 76 (August 4) commented that although "a general spirit of optimism prevailed, the impartial averages again said 'be careful'". That Letter also quoted Rhea on the advantages of avoiding reactions in the third phase of a bull market. On September 4 (Letter 77) I wrote that because of "the extended and uncorrected swing" and because of "the unsatisfactory price movements" I had elected to move to the sidelines myself. Another paragraph added: "It does seem to me that if both averages break the (F) lows on high volume, even long-term investors might take steps to protect themselves against whatever dangers lie ahead". The F lows were broken a few days later. The last Letter (Number 78) spoke of the bearish formations in the two averages, and after stating that "the secondary trend is now down", the Letter went on to say that "there is nothing in the price movement (so far) to imply that the selling is over".

All this notwithstanding, I judge from many letters received that only a small percentage of readers actually took any sort of precautions. Aside from the fact that it is difficult to go against the popular opinion, and perhaps more difficult to act on an abstract theory, I have been barraged with that tired old argument which goes something like this: "How can I sell my stocks when I am subject to all those terrible taxes and commissions?" It is a uniform experience that those who "put away" good stocks for the aforementioned reasons usually end up paying the commission anyway, but they are often relieved of the need for paying the taxes.

"The market is a law to itself", said Hamilton, and he might have added that it is little interested in whether investors are showing profits or losses. Most of us remember that all through 1958 and early '59 the public was praying for a reaction so that fate might give them an opportunity to come in and buy. Finally the public's patience ebbed, and they bought at the highs. The situation is now reversed, and now we find the public praying for a big rally so that they can get out at "even money". The market, however, is noted for its stinginess in bestowing favors upon needy stockholders.

PRICE MOVEMENTS. From the last minor peaks at J (see chart), the market has dropped precipitously lower. The relentless nature of the selling is apparent when one realizes that between points J and K, the averages declined 12 out of 15 days. Thus in a period of

about 3 weeks, industrials fell 47.96 points and rails 13.17 points. Judging by the severity of the J-K sell-off, it was obvious that a sharp rally (if only a technical one) was overdue. The rebound came on September 23 as industrials jumped 7.57 points and rails 2.19. Volume held to the previous day's 3 million shares. September 24 saw a surging advance which together with the previous day served to correct better than 1/3 of the entire J-K decline (See Letter 78, page 3).



The first explosive rebound after a violent decline is never particularly helpful in determining the trend. It is the action subsequent to the rally that will provide the clue. Following the current (K-L) rally, if on the next approach to the K lows (industrials 616.45, rails 150.28) volume contracts and one or both averages hold above the K points, indications will be that the selling is at least temporarily over. Traders might call this a "buy spot". In order for our downward classification of the secondary trend to be reversed, however, minor upward zig-zags would have to form in both averages. The other side of the coin is this: if the two K points are violated on the next decline (particularly on increased volume), it will be obvious that the reaction has further to go.

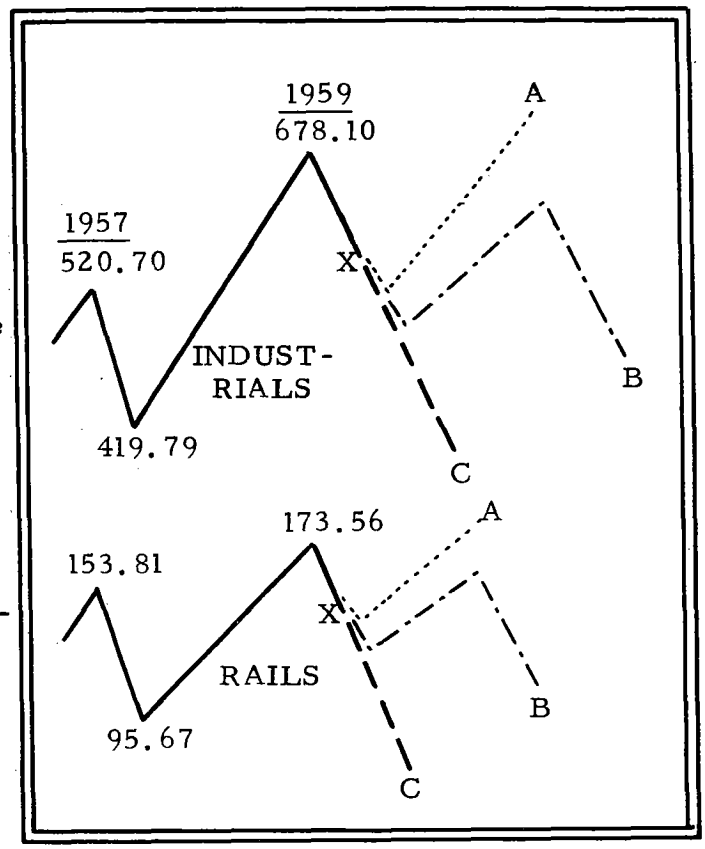
At this writing it is impossible to determine whether the rally from K is a minor upward movement in a continuing secondary or whether it is the beginning of the all-important correction of the entire reaction. The extent and duration of the rally will provide the clue.

The Dow Theory states that a movement is over at the point where the last highs were established (confirmed) by both averages. The last confirmed highs of the current market were hit on July 8, 1959 (the A points). Under this reckoning, the reaction has now lasted well over two months. From their August 3 high of 678.10, industrials have so far retraced 24% of their entire 1957-59 advance. From the July 8 rail high of 173.56, that average has so far retraced 30% of its total 1957-59 gain.

In duration, secondaries tend to last three weeks to as many months; in extent they tend to retrace one-third to two-thirds of the previously uncorrected primary advance. The duration of the present reaction has already fallen within the accepted definition of a secondary. In extent, the downward swing is still on the shallow side. But because of the distinct multi-stage appearance of the retracement so far, I would already classify the move

from July 8 as part (or perhaps all) of a definite secondary reaction. In tabulating every bull market secondary from 1897 to 1953 (there were 58 of them), I arrive at the following figures: the average reaction lasted 57.1 days and corrected 57.6% of the preceding primary swing. If the present retracement were to conform in extent to the average, industrials would react to 530 and rails to 130. Although these figures are based merely on an average, they suggest that the present reaction could have further to go.

THE CHOICES. The chart on this page is included in order to aid readers in visualizing the various alternatives which now present themselves. The averages are currently at point X on chart. If, following whatever lows are now being established, the two averages advance and eventually better their 1959 highs (industrials 678.10, rails 173.56) the primary bull trend will be reaffirmed; this is course A on chart. If the two averages, subsequent to the reaction lows, retrace about one-third or more of the distance towards the highs during a period of a few weeks or so, and (after refusing to better the highs) they then turn down and violate the reaction lows, the primary trend will have turned from bull to bear; this is course B. The final choice would be quite unusual -- if the two averages continue unabatedly lower (without a substantial upward swing), and they finally crack the lows of the last secondary reaction, then the primary trend may be taken as having turned bearish. Since the last reaction lows were the industrial and rail lows of 1957 (419.79 and 95.67 respectively), a violation of these two points following a steady downward swing would signal that a bear market had been in progress since the 1959 highs; that would be course C.



ODD-LOTS. The odd-lotter (under-100-share buyer) who is considered representitive of the general public has been buying consistently and heavily since September, when the reaction first began gathering momentum. Obviously the odd-lotter thinks he is picking up "bargains" as prices work lower. The public's willingness to step up purchases as the market declines is technical deterioration, and the chances are that when the public switches to lighter buying or to actual selling, the downward swing (or the first part of it) will be almost over.

Odd-lot short sales have been very high recently, but as Mr. Drew (the recognized authority on the subject) will tell you, this is about normal. The odd-lot short seller seems to require sharply lower prices before he can work up enough courage to take action.

SHORT POSITION. It is interesting to note that the total short position on the N.Y. Stock Exchange showed an increase of only 63 thousand shares as of September 15 and this while the market was in a steep decline. Because of the recent low volume, the short interest -- average daily volume ratio climbed to 1.29 this month. In my opinion, the short interest and the short ratio are now neutral. The fact that the total short interest did not increase markedly as the market dropped is, if nothing else, not bullish.

OPINIONS. Day after day the market columnists tell us that the selling has been in small lots and not of the institutional variety. This is supposed to imply that the recent selling has been uninformed. Without commenting on the quality of the selling, I will repeat that

I have never been impressed by either the judgment or the perspicacity of the institutions, the banks or the funds. All the institutions together hold only 16.3% of the outstanding stocks on the N.Y. Stock Exchange; mutual funds alone hold less than 4%. Most mutual funds are now heavily invested and probably do not possess large cash surplusses with which to buy. I have long regarded as ridiculous the thesis that the institutions would "hold up the market" in the event of an impending collapse. In my opinion, the institutions will be no more successful than most individual investors in escaping the next bear market. Moreover, the institutions tend to follow each other's leads, and this is a crucial error in investing. For instance, the majority of funds were up to their necks in oil stocks when the 1957-59 swing began; many held a large percentage of oils through the entire advance. Yet the oils have been among the worst actors on the board during the past two years.

EASY MONEY? We are told that the Federal Reserve will not allow a money shortage and that money is already easing up. If the boom continues, however, it is difficult to conceive of a real easing in the demand for money. At any rate, I will continue to put my trust in the averages, not the promises of the money managers. If we are to come out of the present trying situation with flying colors, then the market will see it -- and the averages will eventually better their 1959 highs. It is possible, of course, that the market is weighing new and as yet undisclosed factors. As Hamilton put it, "The market is a barometer. There is no movement in it that has not a meaning. That meaning is sometimes not disclosed until long after the movement takes place, and is still oftener never known at all; but it may truly be said that every movement is reasonable if only the knowledge of the source is complete."

NOTICE. Students of the Dow Theory may be interested in reading the writer's article which is scheduled to appear in this week's Barron's.

(Written September 24 - after the close)